



## GOVERNOR'S TRANSACTION PRIVILEGE TAX SIMPLIFICATION TASK FORCE ONLINE RETAIL WORKING GROUP MINUTES

Monday, September 10, 2012

1:30 PM

1820 W. Washington, St. #200, Conference Room 101  
Phoenix, Arizona 85007

A public meeting of the Transaction Privilege Tax Simplification Task Force was convened on September 10, 2012 in Conference Room 101, 1820 West Washington, St. #200, Phoenix, Arizona 85007. Notice having been duly given. Present and absent were the following members of the Task Force.

### Members Present

Michael Hunter (Chair)  
Steve Barela  
Miguel Teposte  
Tom Belshe

Keely Hitt  
Vince Perez  
Senator John McComish  
Representative Rick Gray

### Members Absent

Linda Stanfield  
Kevin McCarthy

Lynne Herndon  
John Olsen

### Staff Present

Lindsay Scornavacco, Governor's Office

#### 1. Call to Order

Michael Hunter called the meeting to order at 1:30 p.m.

#### 2. Overview of Current Issues

Dennis Hoffman, Chairman of the Online Retail Working Group, opened the meeting with remarks that it is critical everyone read the approved minutes on the TPT website to look for errors and omissions. He hopes the final report from the working group will be reflective of the record of the working group meetings.

#### 3. Presentation: Taxation of Cloud Computing Services and Digital Goods

Stephen Kranz from Sutherland Asbill & Brennan LLP presented on current state tax issues for cloud computing and digital goods.

Mr. Kranz began his presentation stating this was not going to be a discussion of nexus, but of taxability and what should be taxed. The state may impose a tax on something, but the nexus issue could prevent them from collecting. States could tax tee shirts, but if the tee shirt is bought from Amazon the tax may not be collected.

Representative Gray asked if the transaction is taxable when a business located in Arizona buys

cloud based storage from a data center in Arizona.

Mr. Kranz answered yes. He stated there is not a lot of guidance and he disagrees with the guidance that does exist in the state. Departments of revenue around the country interpret laws from the 1940's and 1950's. He suggested these do not mean anything to a modern economy and way of doing business. He continued clear guidance is important. Mr. Kranz compared Vermont to Arizona, saying Vermont decided to repeal the Department of Revenue's position because it was uncertain it was the right policy for the state. The question is if 1's and 0's are tangible personal property.

Mr. Hoffman stated he went to a brick and mortar retailer and bought a thumb drive to store data. He asserted Mr. Kranz's position was that Mr. Hoffman should pay tax on a thumb drive but not to store data in a cloud. Mr. Hoffman asked for clarification on the issue.

Mr. Kranz responded in the first scenario Mr. Hoffman was buying an object in a store that he could pick up and throw.

Mr. Hoffman interjected the thumb drive serves a function.

Mr. Kranz explained sales tax began in order to tax things sold over the counter and not to tax services. He continued services are not widely taxed today; taxes are placed on things you can pick up and throw. A thumb drive is a tangible product of a manufacturing economy. There is nothing that can be picked up and thrown with cloud based storage. Mr. Kranz suggested no one knows where their cloud is located. With the cloud, the consumer gets storage, security, infrastructure, electricity, surge protection and a bunch of other services; it is not the same simple storage as a thumb drive. He gave the example that he brought his presentation on a thumb drive and had he lost the thumb drive he would have been without a presentation. Services come along with storage with the cloud.

Craig McPike from Snell & Wilmer stated the equipment used by the cloud storage provider is subject to tax.

Mr. Kranz responded some states try to incentivize data centers to build in state by providing exemptions for equipment used in data centers.

Mr. Kranz continued his presentation stating characterization drives everything when determining what is subject to tax. Characterization is easy with a thumb drive; you know what it is. Sourcing is easy with a thumb drive; you know where it is from. A fuzzier situation for example is advertising. The customer may be in Arizona paying an advertising agency in Arizona but the advertisement may be played all over the country. Mr. Kranz posed the question of who would then have jurisdiction. Sourcing determinations become very difficult.

Mr. Hoffman asked if everything in the cloud was considered a service. He continued to ask if there are products, which features Mr. Kranz would consider products.

Mr. Kranz responded there is no easy answer. He continued there are four high level definitions in cloud computing terminology: software as a service, platform as a service, infrastructure as a service and unified communications as a service. Each of these terms requires different contributions from

service providers and consumers. The cloud world is very difficult to define and there is no simple way to break it down. Usually someone has no idea where their cloud is located. Someone's information could be backed up in three different locations across the country. Mr. Kranz stated when software was on a disk it was taxed and when software became downloadable from the internet most states agreed it was still subject to tax. With the cloud model, the consumer does not own software. Consumer information is only in the cloud for as long as it is paid.

**a) Working Group Discussion and Public Comment**

Christie Comanita from the Department of Revenue commented the Department's administrative rule was amended in 2006 to specifically add that the sale of software regardless of how it is transferred or delivered is subject to retail use tax. She continued that she disagreed with Mr. Kranz's comment about lack of guidance.

Mr. Kranz responded the problem is based on statutes to which he refers when advising clients.

Ms. Comanita responded there have been six private letter rulings since 2006 that all cite the administrative ruling. She continued it is unfortunate Mr. Kranz picked the one ruling prior to the amendment of the rule.

Mr. Hoffman commented his surprise that something was taxed in Texas and not in California, based on Mr. Kranz's map.

Mr. Kranz explained California has a very robust high tech community and has been able to protect electronics from transaction tax with broad exemptions. There have been proposals across the country that have not been thought out to tax anything delivered or accessed electronically. Mr. Kranz posed the question of whether this could lead to ATM transactions being subject to sales tax. Consumers are paying for a cloud infrastructure to get cash and these things need to be considered. He continued the state of Washington put a lot of thought into their issues which resulted in a very long and complicated piece of legislation. This was necessary to cover all subject areas such as ATMs. Washington decided to tax all services unless there are exemptions, but this is flawed because every new business model then has to lobby for exemptions. Mr. Kranz continued origin based sourcing is extremely counterproductive because it discourages investment. It tells companies they will be taxed if they locate in state.

Keely Hitt asked if there was a state model of which Mr. Kranz approved.

Mr. Kranz answered no. He continued he could pick different elements from different states.

Ms. Comanita thanked Mr. Kranz for coming to the meeting. She continued there is a distinction between Arizona and 90% of the other states because of Arizona's structure of TPT. There is the common thought that services are not taxed, but many are in Arizona. Electricity is not something you can pick up and throw but the courts have ruled it to be tangible personal property. Putting a quarter in a jukebox to hear a song was long ago considered tangible property. Statute was updated with exemptions in 2008. The Department of Revenue is not relying on outdated 60 year old definitions.

Vince Perez commented the group still needs to be mindful of Prop 204 and the impact it could have

on everything being discussed if the base is locked down.

Mr. Hoffman stated when cloud services avoid tax it contributes to the distortion issue regardless of nexus. He continued to completely eliminate distortion the tax rate would need to be zero in both places.

Senator McComish asked how much of a problem this issue is causing cities and the Department of Revenue.

Mr. Perez commented he does not see any issues for the Department of Revenue.

Mr. Hoffman encouraged public participation, stating he is not the only one concerned about distortions.

Michelle Ahlmer from the Arizona Retailers' Association stated taxation on tangible goods is a real problem. She continued the discussion needs to include what services are delivered as a portion of the taxation process.

#### **4. Update on Discussions between Arizona League of Cities and Towns and Arizona Department of Revenue**

Tom Belshe stated that necessary changes to comply with federal legislation have been part of the discussion. One thing that is required is a uniform tax based related to retail sales. He continued his group has taken a look at both tax base models to see if there is any way the state and cities can move closer together and quite a bit of progress has been made. He stated he wishes his document be put on the website for everyone to review and digest so that it can be part of discussion at a future meeting. Mr. Belshe discussed three categories:

- Cities treating an item as the state does
- The state treating an item as the cities do
- City and state treating an item the same, but identical language needs to be drafted

Mr. Belshe stated his group is looking for things that would cause a significant impact on a city's budget. The results of this will also be discussed at a future meeting.

Mr. Perez commented a number of people, including six or seven people from the Department of Revenue, have been thoroughly working through this issue. The group has gotten further than anticipated.

Mr. Belshe stated there are 30 items to work on and the group only has five remaining.

Mr. Hoffman asked if the groups were far apart on the last five.

Mr. Belshe responded there are a lot of things they simply don't know the impact of yet. He gave the example that some cities tax textbooks and the state does not. The group has to see whose budgets would be affected and then determine how far apart they are.

#### **a) Working Group Discussion and Public Comment**

No comments were made.

## **5. Items for Future Discussion**

Mr. Hoffman opened up discussion for future meetings.

### **a) Working Group Discussion and Public Comment**

Ms. Comanita commented she did not mean to shed a negative light on the progress being done between the state and cities but that she has concerns about the streamline effort's requirements. The groups need to be involved in coming up with a common base. She stated she has been looking for an answer to who will determine if states have met the streamline requirements, but has been unsuccessful at the national level. Her major concern is the removal of food from the retail base. She stated that taking food out of the retail category could be a problem with creating a common base.

Mr. Belshe stated he had heard food was taxable.

Ms. Comanita responded the state can treat food however it wants and it is permissible to tax it at a lower rate. This was determined for food and electricity.

Mr. Belshe asked if the state could choose not to tax food.

Ms. Comanita answered the state could have food within its tax base and then each locality can tax at its own rate.

Mr. Hoffman asked why food is not included and just made zero.

Ms. Comanita stated she could not answer that and it is up to the Legislature. She continued letting cities choose could jeopardize eligibility.

Mr. Belshe stated the only reason they considered pulling food out of retail was so it could be exempt or charged at the full rate. The whole reason for moving it was to get rid of green page language.

Mr. McPike commented retail transactions are located under Article 4 in the Model City Tax Code as section 460. Could it be moved and called section 468 still within the TPT and fix the problem?

Ms. Comanita responded the business community in the streamline effort would call that a replacement tax and it would not be allowed. The Marketplace Equality Act allows different rates, but the issue remains that food is not in the state base.

Mr. Kranz stated he does not imagine replacement being a problem under the federal bill.

Ms. Comanita asked if he saw an issue with food being in the cities' base and not the state's.

Mr. Kranz asked if Arizona was like Illinois in that the state taxes food but at a zero rate.

Mr. Belshe said that comment sounded like a recommendation.

Mr. Perez asked since there is already the ability to tax under the current structure if the argument

could be made it is already imposed and it is simply being called a different section.

Ms. Comanita asked Mr. Kranz to answer that question.

Mr. Kranz responded the state should not be looking at the streamline movement. The federal drafts he has seen require a uniform base. He stated it may be safer to repeal the old one and create a new one even if they look, feel and act the same.

Lee Grafstrom from the Unified Audit Committee commented at the city level there is the option to have an exemption for food for home consumption or it is taxable at the same rate for all other retail transactions. The state has an exemption and cities do not, that is a conflict. Mr. Grafstrom asked if the state adopts a zero rate if it is considered a different base.

Mr. Kranz stated there is a difference between an exemption and an exclusion. If something was never in the base and food was moved, it is considered excluded from the base. The state issue sounds like an exemption. He continued he thinks the state could meet the requirements with an exemption.

Ms. Comanita asked if Mr. Kranz knew who will determine if states have met the requirements.

Mr. Kranz responded the answer has changed. Jurisdiction was originally given to the Court of Federal Claims. The current version of legislation says it will be up to the state courts. If a remote seller wanted to challenge the state, it would have to be done in Arizona courts.

Mr. Belshe commented the group should keep in mind that if the state uses the streamline requirements then there is a much broader base than what exists in Arizona. There are many things taxed under streamline that are exempted in Arizona. He continued his group is trying to fix things that are obviously different.

Mr. Kranz stated the federal legislation does require state level participation. Localities create and maintain separate state level points of administration.

Barry Aarons from Aarons Company commented he would still like to discuss online travel companies.

Mr. Perez stated there still needs to be a discussion on sourcing.

## **6. Adjournment**

Mr. Hunter adjourned the meeting at 3:05 p.m.